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SUBJECT: SLOVAKIA STRUGGLES TO COMBAT ECONOMIC CRISIS

SUMMARY

¶1. (SBU) After hoping for several months that it might have dodged the global economic crisis, the GoS has recently begun to face up to the fact that it hasn't. The auto industry has turned in gloomy forecasts, and every week another company or two announces cutbacks, layoffs, or closures. In response, the GoS has brought forth two legislative packages aimed at stimulating new investment, lowering payroll costs, and speeding up infrastructure projects. Local economists complain that the infrastructure projects are problematic, and that most of the measures do not go far enough to keep businesses open.

¶2. (SBU) The GoS intends to finance much of the EUR 330 million package by cutting government spending--to include heavy cuts in transfers to the local and city levels of government--in an effort to keep the deficit below 3 percent of GDP. These cutbacks may negate some of the benefits of the stimulus. Generally, the GoS's reaction to the crisis is slower and less effective than one could wish, but PM Robert Fico appears to be listening to the business community and avoiding potential protectionist pitfalls. End summary.

WAVES OF BAD NEWS

¶3. (U) The news of economic recession began to crash over Slovakia in the latter part of January, as the natural gas crisis was coming to a conclusion. The news here has been growing bleaker by the day. Automakers and their suppliers, a disproportionately large segment of the Slovak economy, have seen sharp drops in orders since October; in December, production was down 35.7 percent from a year ago. The outlook for 2009 is a 25 percent drop from 2008 production. Hyundai/Kia is still running two shifts, but last month it cut the workday from 8 to 6 hours, and it is said to be contemplating a move to one shift. PSA Peugeot Citroen recently announced its first layoff of permanent workers, having already laid off most of its short-term contract employees.

¶4. (SBU) U.S. supplier Molex, which employs 1,000 Slovak workers to produce electrical connectors, announced at the beginning of February that it would close its operation here over the next year. U.S. Steel, whose Kosice plant supplies materials mostly for household appliances and the auto industry, is down 50 percent in new orders and is idling its workers one day a week at 60 percent pay. Most producers and

suppliers have resisted layoffs, favoring cutbacks in working hours.

¶5. (U) Though the automotive industry is the hardest and earliest hit, the recession is being felt across the board. Real estate values are falling, and the construction industry with them, and even the relatively robust services and technology sectors are contracting. At least two U.S. companies are approaching the Slovak Government with proposals to re-open their investment incentive packages as they consider global restructuring. Overall economic growth estimates have been dropped from 7 percent to 4.6 percent to, most recently, the 2 - 2.5 percent range, and many expect further downward revisions.

THE GOS REACTS

¶6. (U) Late in January, the government formed the "Committee for the Financial Crisis," composed of key ministers, parliamentarians, labor unions, industry groups, and bankers. The group has proposed two packages of emergency measures, the so-called second and third crisis packages (the "first package" was a bundle of 27 measures aimed at preventing the spread of the financial crisis to Slovakia), and a budget of EUR 330 million in crisis funding. Further packages are expected as the situation continues to deteriorate and industry demands stronger measures.

¶7. (U) The second package, approved in early February, includes government grants for newly self-employed workers, for creating so-called "social enterprises" (essentially

community make-work programs aimed at long-term unemployed), subsidies for commuting, and grants to cover social insurance deductions for employers furloughing workers at 60 percent wages (on the U.S. Steel model). The third package, just passed in parliament, includes a higher floor for personal income tax (from EUR 3435 to EUR 4026 annual compensation), additional tax deductions for self-employed workers, quicker reimbursement for VAT returns (from 60 to 30 days), a lower threshold for investment incentives, concessionary financing for small businesses, employment retention incentives for distressed businesses, and a government guarantee on mortgages. Both packages also contain a number of minor measures to encourage new investment.

THE CRITICS WEIGH IN

¶8. (SBU) The government is also aiming to accelerate the start of a series of highway construction projects using public-private partnerships (PPPs) and EU structural funds. The PPP projects, already delayed and fraught with charges of opaque tender proceedings and cronyism, have run up against the credit squeeze, and the GoS is considering funding these itself. The most widely shared criticism of these projects is that the GoS would be better served using the hard-to-spend EU monies on these projects, rather than attempting to manage two large baskets of highway construction--much of it as yet unplanned. As well, suspicions of corruption have turned much of the Slovak public against the PPP; most economic experts would rather see the money channeled through the higher auditing standards of the EU.

¶9. (SBU) A more telling criticism among economists is that the packages contain mostly half-way or misguided measures that do little to keep people employed. Since Slovakia depends heavily on exports, there is little to be done to stimulate domestic demand, apart from plussing up government spending. New investment, the goal of many measures from both packages, is not a real possibility in today's credit- and

cash-poor environment. That leaves only one additional target for the stimulus: employment, and the GoS's measures are generally thought not to be sufficient to keep businesses open with a full workforce.

FINANCING STIMULUS WITH SPENDING CUTS

¶10. (SBU) Perhaps the most unrecognized problem is the proposed method of financing the EUR 330 million effort. Socialist PM Robert Fico, having got anti-deficit religion from Slovakia's euro adoption process, has become fixated on keeping budget deficits to a minimum. It was not until late in 2008 that he publicly entertained the possiblity of relaxing the 1.7 percent goal agreed internally in mid-2008. More recently, he has been setting expectations in the 2.5 percent range, though gradually conceding that the crisis may require going all the way to the Maastricht ceiling of 3.0 percent. While economists generally like fiscal discipline, they have begun calling for even more flexibility on deficit ceilings until economic trends swing upward. OECD Secretary-General Angel Gurria made this point during a visit earlier this week.

¶11. (SBU) If the deficit ceiling is sacrosanct, how to raise EUR 330 million for the stimulus packages? By cutting other government spending, especially funding for local governments. Conventional wisdom would say this is an especially bad time to rob local governments, but the local community of economists has yet to raise its collective voice against this line of cannibalistic thinking.

COMMENT: IT COULD BE WORSE

¶12. (SBU) All in all, the reaction to the crisis is better than one might expect from a Slovak government that describes itself as socially oriented. The government is properly focused on employment, and it is talking to businesses about what they need to stay open. While far from perfect, the stimulus packages do at least try to address the needs of

employers and the working (and recently laid off) public. The government could do more to bring in the ideas of the pro-business opposition, which it has gone out of its way to spurn. But that constituency has offered mostly recycled ideas for stimulating new investment through tax breaks (including a reduction in the flat tax rate) and streamlined government. At least the GoS has ignored the calls of unions, older industries, and agricultural businesses to combat the recession with a slug of old-fashioned protectionism.

¶13. (SBU) Of more concern is the slowness with which the GoS has grasped the situation and its limited reach for ideas to deal with it. Fico's idee fixe of financing the stimulus out of hide may well negate much of the positive effect of accelerated public spending. By the same token, the failure to understand that public spending has to happen within the next 6-12 months to have an effect may lead to a procyclical inflationary trap as the economy revives itself. This is a hard time for Fico to learn economics on the job, but he has done this once before, with the successful adoption of the euro. And this gives us some cause for hope.

EDDINS